

Depot Sales of Goods and Services to Private Parties

Pricing in Partnering Agreements

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INTRODUCTION

Public-private partnerships are agreements among organic depot maintenance activities and private industries or other entities to perform work or utilize facilities and equipment.¹ As a result of DoD and congressional encouragement—including enabling legislation—the number of these agreements has increased steadily over the last several years, but continued growth is not assured.

A recent General Accounting Office (GAO) report notes DoD depot maintenance performed under partnership agreements represents only a small percentage of the total value of depot maintenance work, and the probability of a significant increase is uncertain.² Clearly, the potential for growth is dependent upon the appeal of the agreements to the private sector. This, in turn, is affected by the conditions placed on the agreements by prospective government partners.

LMI was tasked by the Deputy Under Secretary of Defense Logistics and Materiel Readiness, to identify financial management impediments to public-private partnering and recommend appropriate changes to law, regulations, and practices. This paper focuses on a particular set of financial management issues that directly affect partnering agreements.

¹ Deputy Under Secretary of Defense Logistics and Materiel Readiness (DUSD[L&MR]) memorandum, *Public-Private Partnerships for Depot Maintenance*, January 30, 2002.

² Depot Maintenance, *Public-Private Partnerships Have Increased but Long-Term Results Are Uncertain*, GAO-03-423, April 2003.

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FINANCIAL MANAGEMENT ISSUES

Genuine business partnering initiatives that involve public- and private-sector activities represent a paradigm shift relative to traditional “buyer-seller” arrangements. A successful partnership must feature higher levels of mutual trust, shared expectations, and shared risk than less collaborative business arrangements. Because the effort to build strong public-private partnerships within the Department of Defense is a relatively new phenomenon, there is little enabling policy readily at hand to guide management decisions. In many cases, current policy has the effect of unintentionally frustrating partnering initiatives. A recent survey of DoD and industry partnership participants³ identified a number of financial management provisions that differ from standard industry practices, add complexity, and—most importantly—make it difficult to appropriately redistribute financial risk among the enterprise’s partners. A number of private industry and DoD depot representatives were interviewed to gain additional insight into these financial management concerns.

The focus of this paper is on four specific issues raised in these interviews. They concern the prices of items and services sold by DoD depots to private-sector partners and when those prices must be paid:

- ◆ *Pricing basis.* Depot charges are sometimes unrelated to the actual cost of items or services sold. This can be addressed by revising the DoD Financial Management Regulation (FMR)⁴ to encourage tailored pricing for sales to private parties. Prices should exclude factors to recover prior-year operating losses, surcharges, and overhead costs not related to the cost of producing goods and services sold under the partnership agreement.
- ◆ *Fixed pricing.* DoD activities do not always establish definitive prices that remain unchanged during a fiscal year. This issue can be resolved by revising the FMR to encourage the use of firm, fixed-price agreements in the sale of goods or services to private partners.
- ◆ *Multiyear fixed pricing.* DoD depots cannot establish predictable prices beyond the current fiscal year. This issue can be addressed by revising the FMR to authorize and encourage the use of multiyear fixed-price agreements in the sale of goods and services to private partners. In addition, a small contingency factor can be included in the sale price to offset any potential operating losses and to fund marketing initiatives.
- ◆ *Advance payment.* Private-sector partners must pay for goods or services *before* a DoD activity can even begin work. This issue can be resolved by

³ Conducted in conjunction with a meeting of the Action Group on Depot Maintenance Partnering, November 21, 2002.

⁴ DoD 7000.14-R, DoD Financial Management Regulation.

revising the FMR to emphasize the ability to employ small incremental payments for private-party sales.

CURRENT ENVIRONMENT

Congress has encouraged partnering arrangements by enacting a number of changes to the law, with the intention of encouraging and facilitating public-private partnership agreements.⁵ Provisions of the law permit a wide range of co-operative agreements. Current statutory requirements and DoD policy concerning the pricing of sales to private parties (and the disposition of the proceeds of such sales) through the Defense Working Capital Fund (WCF)⁶ are summarized in Table 1. Appendix A contains the highlights of applicable legal provisions and defense policy that affect the pricing of sales to private entities.

Table 1. Current Statutory Requirements and DoD Policy

Authority	Requires that WCF prices... ^a
10 USC 2208 ^b (WCF authority)	include the charges necessary to recover the full cost of goods and services. do not include depreciation for military construction or base realignment and closure costs.
10 USC 2474 (partnerships)	reimburse DoD for the direct and indirect costs attributable to a private entity's use of equipment or facilities. (Does not address the pricing of goods and services.)
10 USC 2539b (availability of samples, drawings, information, equipment, and testing services)	for testing service fees may not exceed the amount necessary to recoup the direct and indirect costs involved.
10 USC 2563 (non-ordnance sales outside DoD)	charge private parties, at a minimum, the variable costs, capital improvement costs, and equipment depreciation costs associated with articles or services sold.
10 USC 4543 (ordnance sales outside DoD)	charge private parties, at a minimum, the variable costs associated with commercial articles or commercial services sold.
22 USC 2770 (sale of defense articles pursuant to sale of an end item to a friendly foreign government or international organization)	are negotiated based upon a price that is not less than the replacement value or actual cost.
10 USC 7300 (shipyard sales) DoD 7000.14-R DoD FMR (DoD financial policy)	exempt shipyard sales to a private shipyard from sections 2208 and 2563 when the private shipyard is performing a DoD contract with respect to a nuclear ship. recover full cost, including general and administrative support provided by others and unfunded costs (such as civilian retirement-related accruals). deposit receipts associated with unfunded costs in the U.S. Treasury.

^a Not a comprehensive list of requirements.

^b Read as Title 10, U.S. Code, Section 2208.

⁵ “Public” entities are government facilities supported by the taxpayer such as naval shipyards and army depots, while “private” entities are non-federal corporations, companies, or individuals.

⁶ Volume 2B, Chapter 9, of DoD 7000.14-R describes the Defense WCF as “Revolving funds...established to satisfy recurring Department of Defense requirements using a businesslike buyer-and-seller approach.” Activities funded in this manner operate on a self-sustaining basis, much as independent businesses, providing goods and services to others on a reimbursable basis.

Public-private partnership agreements encompass several different types, and the reasons given for entering into the agreements vary. The most common partnership is the “sale of services,” and the most frequently quoted reason for entering into a partnership involving sales by a DoD depot to a private party is the “unique capability of the DoD depot.” Additional information is provided in Appendix B (authorities under which partnerships can be established), Appendix C (the types of partnerships), and Appendix D (the reasons for entering into partnerships).

DISCUSSION

There are a number of potential changes to the FMR that might enhance partnering initiatives. For example, it would be useful to summarize legal authorities in the FMR. Existing statutes pertaining to partnering (such as 10 USC 2563, which permits pricing certain sales to recover only variable costs plus depreciation and capital improvement) have not been addressed in the FMR. The Secretary of Defense has wide latitude to establish policies designed to recover reimbursable costs incurred by WCF activities that provide goods and services for DoD and other customers, so it should be possible to implement policy changes designed to promote public-private partnerships.

The following analysis of the four significant pricing issues includes the alternatives and recommendations for possible policy changes designed to further encourage and facilitate DoD depot sales to private partners.

Pricing Basis

Depot charges (for costs or other purposes) are sometimes unrelated to the actual cost of items or services sold.

BACKGROUND

As the DoD depots invoke the full range of the policies cited in Table 1, the basis for pricing of sales to private entities is not always consistent and is sometimes viewed by private-sector partners as inequitable. The consequence of differing rules for each circumstance is added administrative burden, which contributes to inefficiency, added cost, and greater opportunity for error and inconsistent interpretation of the rules. Table 2 illustrates some of these differences.

Table 2. Examples of Statutory Requirements for Pricing DoD Sales to Industry

Authority	Requirement
10 USC 2208	<ul style="list-style-type: none"> • WCF charges shall include amounts necessary to recover the full cost of those goods and services provided. • Charges may not include depreciation for military construction or costs related to base realignment and closure. • Does not specifically address the pricing of sales to private entities — thereby affording the Secretary of Defense wide latitude in establishing operating rules and setting prices to recover costs incurred on behalf of customers.
10 USC 2474	<ul style="list-style-type: none"> • Direct and indirect costs attributable to a private entity's use of equipment or facilities shall be reimbursed. • Does not address the pricing of goods and services sold to private parties.
10 USC 2539b	<ul style="list-style-type: none"> • Fees are not to exceed the direct and indirect costs of providing the services of a laboratory, center, range, or other testing facility. • Does not address pricing of sales or rental of samples, drawings, manufacturing information, equipment, or materials.
10 USC 2563	<ul style="list-style-type: none"> • Private parties are charged, at a minimum, the variable costs, capital improvement costs, and equipment depreciation costs associated with the articles or services sold.
10 USC 4543	<ul style="list-style-type: none"> • Private entities are charged, at a minimum, the variable costs associated with the articles or services sold.
10 USC 2770	<ul style="list-style-type: none"> • Prices for sales based upon a negotiated contract shall not be less than the replacement value or actual cost of the services.

The term “variable costs,” used in both 10 USC 2563 and 10 USC 4543 with respect to sales of articles or services, refers to the costs expected to fluctuate directly with the volume of sales and

- ◆ the production necessary to satisfy the sales orders (in the case of articles) or
- ◆ the extent of the services sold (in the case of services).

Unlike variable costs, which change in proportion to the volume of production, fixed costs remain unchanged (at least in the short term), regardless of the volume of production. Examples of variable versus fixed costs are listed in Table 3.

Table 3. Variable Versus Fixed Costs

Variable costs	Fixed costs
Direct labor	Depreciation
Direct materials	Rent
Shipping costs	Executive salaries
	Building maintenance

Many costs cannot be defined strictly as either fixed or variable. In the long term, all costs are variable; but in the near term, many are semi-variable or may be categorized only in terms of a specific set of circumstances. For example, production supervision increases in steps, depending upon the size of the overall workforce. Supervisory costs are fixed within a limited range, but they typically increase if additional shifts or a substantial number of direct-labor workers are added.

DoD policy stated in the FMR requires WCF sales prices be set to recover the full cost⁷ of delivering goods or services, including general and administrative support provided by others.⁸ For sales to private parties, the FMR requires the buyer be charged for the full cost incurred by the federal government, including any unfunded costs not charged to DoD customers.⁹

- ◆ For WCF activities, unfunded costs include
 - civilian retirement and post-retirement health benefits that are not funded by DoD and
 - any interest on investments in assets acquired for or prepared for use in providing material to private parties.
- ◆ For direct appropriation-funded activities such as “mission funded” shipyards, unfunded costs include depreciation of assets, based on either actual data or on a factor (4 percent) developed by the Office of the Secretary of Defense (OSD) Comptroller.¹⁰ Amounts collected to cover these unfunded costs must be deposited in the U.S. Treasury.
- ◆ The FMR does not address the use of variable (or marginal) cost recovery for determining prices charged for goods or services as authorized for sales under 10 USC 2563 and 10 USC 4543.

WCF sales prices—most often expressed as a dollar amount per direct labor hour—are set in the budget process to recover costs over multiple years and to protect DoD appropriated account programs from unexpected cost increases by stabilizing the billing rates or prices. Budget year prices are set to recover estimated budget year costs plus an amount to compensate for accumulated operating losses (or gains). In addition, surcharges may be added for specific purposes, such as to provide additional operating capital or to provide cash to increase the level

⁷ Office of Management and Budget (OMB) Circular A-25, paragraph 6(d), defines the term full cost as “all direct and indirect costs to any part of the federal government of providing a good, resource, or services.”

⁸ DoD 7000.14-R, Volume 2B, Chapter 9, paragraphs 090103.H and 090104, and Volume 11B, Chapter 11, paragraph 110102.

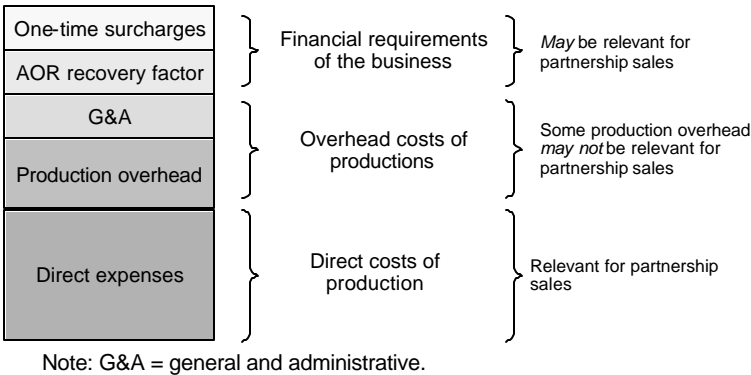
⁹ DoD 7000.14-R, Volume 11A, Chapter 1, paragraph 010201, and Volume 11B, Chapter 11, paragraph 110109.B.

¹⁰ DoD 7000.14-R, Volume 11A, Chapter 1, paragraphs 010201.B and 010201.G.

of capital equipment investment. The goal is to achieve zero accumulated profit or loss¹¹ by the end of the budget year, although recovery of prior-year operating losses over a 2-year period is sometimes approved.

Price setting begins with the initial formulation of activity budgets approximately 18 months before the beginning of the budget execution year, and final DoD approval of WCF budget rates occurs about 9 months before the beginning of the fiscal year. Figure 1 illustrates the relationship of WCF price components to partnership sales.

Figure 1. Price Components



The stabilized WCF rates and prices established in the budget process remain unchanged during the year of execution, unless the depot activity experiences an operating loss. In this case, the FMR requires that depot maintenance activities recoup any unbudgeted losses or gains in excess of \$10 million from current-year budgets (rather than through out-year prices).¹² In many cases, the one-time recoupment is accompanied by a mid-year change in prices, including to the prices charged to non-DoD customers.

A telephone survey of several DoD WCF management officials indicates most WCF activities now charge stabilized rates established in the budget process when performing work for private parties under partnering arrangements. In some instances, the rates or prices are modified by exclusion of Accumulated Operating Result (AOR) recovery surcharges, and production overhead costs are sometimes eliminated when government personnel are essentially on loan to a private entity. For example, in some aircraft component repair sales, the private partner is charged the DoD standard component unit price less the cost for material when the private partner furnishes it.

A representative of one defense contractor involved in a longstanding partnership with a DoD depot noted a trend in recent years for program managers to initiate

¹¹ Identified for Defense WCF activities as the Accumulated Operating Result, or AOR.

¹² DoD 7000.14-4, Volume 2A, Chapter 1, paragraph 010218.B and Volume 2B, Chapter 9, paragraph 090103.H.

partnership arrangements as workshare assignments rather than as direct DoD depot sales. In workshare agreements, the program manager directly assigns work to the DoD depot and to the private contractor then pays each party separately. A DoD manager at a different DoD depot expressed a preference for workshare arrangements rather than direct DoD sales to private partners based upon the belief that direct sales to a private party executing a DoD contract increases the cost to the government. According to the manager in this situation, the private partner increases the cost of the DoD-performed work with the addition of its own overhead and profit factors before billing the government. These opinions likely contribute to decisions by some program managers to arrange workshare partnerships rather than direct DoD sales to private partners.

ASSESSMENT

As previously stated, stabilized WCF prices are developed a year and a half in advance of execution, with final OSD approval occurring approximately 9 months in advance. As a result, these stabilized rates may not represent the current cost of doing business. Prices charged for sales to private partners may be higher or lower than needed to recover actual costs.

A more accurate relationship between the cost of producing goods or services and prices charged could be achieved by basing prices on the most recent cost estimates rather than on the stabilized prices charged DoD customers. This approach would exclude the impact of any current-year surcharges or price adjustments to recover unbudgeted operating losses. With prices and resultant revenue based upon the most recent actual cost data, the probability of incurring operating losses or gains on sales by WCF activities would be diminished. (For non-WCF activities, prices charged are based on current cost data, and not set in advance as part of the budget process.)

Including the AOR recovery (or payback) factor in WCF rates often has a significant effect on year-to-year price fluctuations. An AOR recovery factor included in budget rates is less attributable to sales to specific private partners than to past DoD customers because partnerships remain a relatively small proportion of overall workload. While DoD depot sales to DoD customers remain relatively constant from year to year, the same is not necessarily true of DoD depot sales to a particular private entity. Excluding the effect of AOR recovery (or payback) factors in the pricing of sales to private partners would better stabilize year-to-year pricing changes. The resultant prices would more closely mirror current costs, and the probability of operating gains or losses during that period would be reduced.

In addition, there are often overhead costs included in WCF rates that may not be applicable to goods or services sold to private partners. The flexibility to exclude extraneous costs and tailor rates to the specific circumstances could help bolster sales to private partners. Some DoD depots currently exclude unrelated production costs from prices charged to private entities for work performed at the private partner's facility. For example, when a naval shipyard worker performs work at a

private shipyard as part of a partnering agreement, the private shipyard is not charged for unrelated production overhead, such as the cost of maintaining cranes at the naval shipyard.

A revised FMR policy that bases prices to private partners on recovery of current costs—excluding AOR recovery factors, surcharges, and overhead factors not related to the work performed—would be consistent with the pricing guidance contained in 10 USC 2563 and 10 USC 4543 and would extend a consistent policy to all private-party partnering sales. Sections 2563 and 4543 require private buyers be charged, at a minimum, the variable costs associated with the articles or services sold. Further, 10 USC 4543 requires regulations that authorize a facility to charge the buyer, at a minimum, the variable costs associated with the sales.

On the other hand, use of DoD stabilized rates and prices to bill for all workload, including that for private-entity partners, has some advantages. There is less administrative burden when standard, established rates and prices are universally applied, as opposed to deriving and accounting for different rates for each unique circumstance. Furthermore, it could be argued that application of the standard stabilized rates and prices to all customer work is the most equitable approach, because no customer is favored over another based on price. However, this approach:

- ◆ does not contribute to the DoD goal of pursuing partnerships in order to strengthen depot maintenance operations, and
- ◆ may lead to underpricing when a WCF sets its stabilized rates and prices to return an accumulated profit to its customers.

Proposing new legislation to consolidate the various statutes to simplify and unify the rules for sales to private parties may further the objectives of public-private partnerships, but it may be difficult to obtain the necessary executive branch support and congressional approval. Given the relatively wide latitude granted to the Secretary of Defense by 10 USC 2208 to prescribe rules and regulations for operation of WCF activities, it should not be necessary to seek new legislation to implement pricing policy changes designed to enhance the objectives of public-private partnering.

ALTERNATIVES

There are several possible FMR policy changes to pricing DoD depot sales to private entities in public-private partnering arrangements that would enhance the likelihood of increasing DoD depot sales to private parties in public-private partnership agreements. We identified four pricing alternatives:

- ◆ *Current cost pricing.* Revise FMR policy to require sales to private entities be based on full recovery of current costs, rather than on stabilized rates and prices established in the budget process. This applies only to

WCF activities, as non-WCF activities already base pricing of sales to private parties on current costs.

- ◆ *Tailored pricing—option 1.* Revise FMR policy to base sales to private partners on recovery of current costs, as above. In addition, exclude AOR recovery factors, surcharges, and overhead factors not related to the work performed.
- ◆ *Tailored pricing—option 2.* Revise FMR policy to exclude from prices charged to private partners any AOR recovery factor, surcharges, or overhead factors not related to the work performed. This differs from the tailored pricing (option 1) in that pricing factors are based on the stabilized budget rate rather than current costs.
- ◆ *Stabilized prices and rates.* Utilize stabilized prices and rates—without adjustment—for the sale of goods and services to private partners.

RECOMMENDATION: TAILORED PRICING—OPTION 1

We recommend the FMR be revised to incorporate the provisions of the tailored pricing (option 1) for sales to private parties in public-private partnerships. Prices based upon the current cost of operations—excluding AOR recovery factors, surcharges, and overhead factors not related to the work performed—would be more stable from year to year and, therefore, more predictable in the future. Excluding AOR recovery factors and other potential surcharges would leave pay raises, general inflation, and the volume of business as the major items influencing year-to-year price changes. Revenue from prices based on current cost is more likely to produce zero operating gains and losses than revenue based on prices fixed 9 to 18 months earlier. Prices for goods or services produced by DoD depots for private partners would be more competitive and equitable, with the exclusion of overhead costs that are clearly not related to the cost of production.

Fixed Pricing

In some cases, DoD activities do not establish definitive prices that remain unchanged during a fiscal year.

BACKGROUND

This issue concerns whether—and when—government partners should commit to firm, fixed prices rather than cost-reimbursable pricing based upon hours worked or cost incurred.

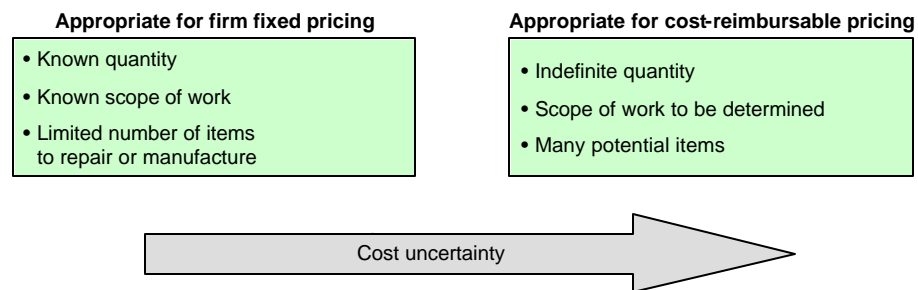
A firm, fixed-price order establishes a price for the purpose of reimbursement for a specified product.¹³ In the depot maintenance business, the output or product can range from repair of a small component to the major overhaul of a nuclear

¹³ DoD 7000.14-R, Volume 11B, Chapter 2, paragraph 020702.

ship. Fixed-price agreements may apply to a large number of the same units or a unique job. A final price may be agreed upon before preparation of an order or may be decided upon after work commences. For example, the customary practice at naval shipyards for large one-of-a-kind projects (such as the overhaul of a nuclear ship) is to enter into a fixed-price agreement with the customer only after a significant amount of tear down and inspection is complete and the exact work to be done is known. Under cost-reimbursable pricing, the government's billing is usually based on direct labor hours expended—at a stabilized or actual cost rate—plus the cost of any other direct charges, such as material or travel.

For the customer, the principal difference in fixed-price agreements is the seller (the government) bears the risk of cost overruns. In cost-reimbursable agreements, the buyer (the private-sector partner) bears the risk. Figure 2 illustrates this relationship.

Figure 2. Fixed Versus Cost-Reimbursable Pricing



Sales under the provisions of 10 USC 2563 and 10 USC 4543 require either a firm, fixed-price contract or, if agreed to by the purchaser, a cost-reimbursable contract. The FMR requires stabilized billing rates be established in the budget process,¹⁴ which could be viewed as a form of partially fixed pricing. Stabilized rates for depots are most often stated as an amount per direct labor hour (or per man day in the case of shipyards). The FMR also permits depot maintenance WCF activities to maintain a catalog of products and services that includes standard work package direct labor hours. These standard hours multiplied by the appropriate stabilized hourly rate constitute a firm, fixed price for the catalog item.¹⁵

ASSESSMENT

The FMR permits work on a fixed-price basis by any DoD depot maintenance activity, whether in the WCF or directly funded by an appropriation.¹⁶ To quote a firm, fixed price, however, the work specification must be stable, specific, and definite. When feasible and reasonable, establishing a fixed price can benefit both parties. Customers are more likely to enter into a fixed-price agreement than into

¹⁴ DoD 7000.14-R, Volume 11B, Chapter 1, and Volume 2B, Chapter 9, paragraph 090104.

¹⁵ DoD 7000.14-R, Volume 2B, Chapter 9, paragraph 090204.B.

¹⁶ DoD 7000.14-R, Volume 11A, Chapter 2, paragraph 0207.

an agreement based upon cost reimbursement because they can then better proceed with other financial planning without the risk of losing money because the price of a purchase might increase later.

The fixed price not only establishes a cost goal for the performing activity to avoid a financial loss, but also presents an opportunity to produce an operating gain. Direct funded (i.e., non-WCF) activities cannot absorb operating losses for future year recovery. Accordingly, the FMR adds special caution that a direct funded activity should not accept a fixed-price order unless the completion cost can be predicted with a high degree of certainty to avoid violating the prohibition against inappropriately augmenting an appropriation or using an appropriation for a purpose not intended.¹⁷ As a result, under current policy, many depot commanders may be reluctant to commit to a firm, fixed price.

In addition, most DoD maintenance depots are primarily job shops in which the repair requirements vary from item to item, rather than manufacturing activities that produce significant numbers of the same item. The potential variability in each repair job can make local managers reluctant to fix the repair price for a particular item until that item is disassembled and the repair cost can be accurately estimated.

Many partnering arrangements involve sales by a DoD depot to a contractor that fulfills a fixed-price DoD contract. When depot prices are unpredictable from year to year and subject to significant change, private partners may have difficulty pricing their own work and, therefore, be discouraged from purchasing goods or services from DoD depots. Operating gains and losses from sales to private entities are not differentiated from sales to DoD customers. The normal budget procedure is to offset the impact of such gains or losses in the next budget's stabilized rates.¹⁸

¹⁷ DoD 7000.14-R, Volume 11A, Chapter 2, paragraph 020702.A. Several sections of law establish the principle that money may be spent only for the specific purpose for which it was appropriated. For example, 31 USC 1301 states appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law. 31 USC 1341 also states that an officer or employee of the U.S. government may not authorize an expenditure or obligation that *exceeds* the amount available in an appropriation or fund or involve the government in a contract or obligation *before* an appropriation is available unless authorized by law. Moreover, 31 USC 1517 states that an officer or employee of the U.S. government may not make or authorize an expenditure or obligation exceeding an apportionment. (OMB apportions or allocates appropriated funds, usually on a quarterly basis.)

¹⁸ In other words, recover the partnership's profit or loss—along with the profit or loss from all other work—through the standard rates and prices charged to all customers.

ALTERNATIVES

Although current policy permits the use of firm, fixed-price agreements in sales to private entities, the FMR does not specifically recommend or encourage the practice in order to further the goals of public-private partnering. We identified two fixed-pricing alternatives:

- ◆ *Revise FMR policy* to encourage firm, fixed-price contracts for sales to a private partner by a WCF depot or by a non-WCF depot. Promoting the use of fixed-price orders in the FMR may encourage commanders to make greater use of fixed pricing in negotiating terms for performance of work for private partners. This could result in increased public-private partnering sales to private entities because purchase prices for specific deliverables would be fixed and predictable, at least for the current fiscal year.
- ◆ *Continue current practice with no change to FMR policy.* This option would not contribute to the goal of increasing the use of public-private partnering agreements to accomplish DoD depot maintenance.

RECOMMENDATION: REVISE FMR POLICY

We recommend the FMR be revised to encourage the use of fixed-price agreements in the sale of goods and services to private partners to further the objectives of public-private partnering. An option to accommodate the operating losses or gains that result from fixed-price agreements (that is, a contingency factor) is discussed under the alternatives for the multiyear fixed pricing issue below.

Multiyear Fixed Pricing

DoD depots cannot establish predictable prices beyond the current fiscal year.

BACKGROUND

This issue concerns the ability to establish predictable prices beyond the current fiscal year. The various provisions of law and the FMR do not provide definitive guidance as to the use of multiyear, fixed-price sales to parties outside DoD. 10 USC 2563 and 10 USC 4543 require the use of a firm, fixed-price contract or, if agreed to by the purchaser, a cost-reimbursable contract for sales to private entities; however, they do not address whether the price agreement is restricted to the year of execution or may be effective for a number of years.

Two industry representatives indicated that dealing with the government is sometimes difficult because the government is less able than commercial contractors to commit to specific numbers of units for future years. Volume is a major factor in the cost of production and in pricing of sales. Because DoD depot sales to private partners are often in support of, or in conjunction with, the private partner's sales to the government, this uncertainty regarding future volume is a complicating

factor for both parties. Unfortunately, little can be done to mitigate this problem: Government purchases are subject to annual appropriations by Congress, and government activities are prohibited from undertaking financial obligations in advance of the appropriations.

ASSESSMENT

The FMR appears to allow the concept of multiyear pricing, stating that the stabilized rate will be charged for all new customer orders received and accepted during that year, regardless of the fiscal year in which the work is actually executed and billed.¹⁹ The requirement that work begin within a reasonable time (usually 90 days) after receipt of a project order²⁰ seems contrary to a multiyear agreement to fix the price of work to be inducted in future years.

There are two potential approaches to resolving the apparent inconsistency in FMR policy guidance: a new Title 10 section or a new FMR policy authorizing the use of multiyear fixed-price agreements with private parties in partnering agreements. A new authorization appears to be within the authority granted to the Secretary of Defense by 10 USC 2208(h) to prescribe regulations governing the operation of WCF activities and the use of inventories granted by this section. Therefore, a change to statutory language does not appear to be necessary.

Definitive authorization to enter into multiyear fixed-price agreements would give depot activities greater flexibility in negotiating terms for performance of work for private partners. Sales to private entities might increase, especially when the private partner is executing a fixed-price contract; however, it is possible government legal experts may determine that authorization to enter into multiyear firm, fixed-price contracts for sales to private parties would require explicit statutory authorization. This is more likely to be the case for non-WCF depots, because they do not have the authority to recover operating losses (or gains) over time. A policy authorizing the use of multiyear fixed pricing might have little impact in practice, because the risk of operating losses in future years might deter commanders from entering into multiyear fixed-price contracts.

To provide depot commanders with greater latitude to commit to multiyear fixed prices, a special partnering sales support account could be established to offset any potential losses on work performed for private entities. Including a contingency factor in prices charged to private partners would finance such an account. This contingency factor should be determined locally, be based upon the risk involved, and be relatively small—perhaps limited to a 5-percent addition to the sale price. In addition to absorbing private sale operating losses, the account could also be made available to finance bids and proposals or other marketing efforts to further partnering objectives. This would reduce the likelihood that private sales

¹⁹ DoD 7000.14-R, Volume 2B, Chapter 9, paragraph 090104.B.1.

²⁰ DoD 7000.14-R, Volume 11A, Chapter 2, paragraph 020510.

losses might be borne by DoD-appropriated fund customers and could increase sales to private partners.

Including a contingency factor would slightly increase prices to private-sector partners, making partnership costs somewhat less attractive. There would still be some risk that operating losses on private sales would be greater than the amount available in the separate account and would be recovered from appropriated sources.²¹ Existing accounting systems also may require some modification to separately track operating results for sales to private entities.

ALTERNATIVES

We identified three multiyear pricing alternatives:

- ◆ *Revise FMR policy to encourage the use of multiyear fixed-price contracts* (in the case of sales by a WCF or non-WCF depot to private partners) when there is a minimal risk of incurring an operating loss. Multiyear fixed-price agreements should account for anticipated cost changes for labor and materials as estimated by OMB.
- ◆ *Revise FMR policy to explicitly permit the inclusion of a small contingency factor*, determined locally based upon the assessed risk, to WCF depot sale prices charged to private partners. Proceeds from the contingency factor plus accumulated operating gains and losses that relate to private-partner sales would be placed in a separate account. This account would offset any operating losses attributable to private-sector sales and would be available for preparation of bids and proposals or other marketing efforts to further the objectives of public-private partnering.
- ◆ *Propose new Title 10 legislation* to clearly authorize multiyear fixed-price contracts for sales to private-entity partners and to authorize contingency accounts to offset any private sale losses or gains and finance marketing initiatives.

RECOMMENDATION: REVISE FMR POLICY

To further the objectives of public-private partnering, we recommend that FMR policy be revised to

- ◆ encourage multiyear firm, fixed-price contracts for sales by a WCF or non-WCF depot to a private partner as described above; and

²¹ This can happen under the current financial policy. When losses occur on private-sector sales they are treated no differently from DoD losses and recovered from all future customers. DoD customers fund the loss if there are no future private-party customers.

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- ◆ permit the inclusion of a contingency factor in WCF depot sale prices to a private partner to offset private sale operating losses and fund marketing initiatives.

Advance Payment

Private-sector partners must pay for goods or services before a DoD activity can commence work.

BACKGROUND

The FMR prohibits work or services being performed by a WCF activity except on the basis of reimbursable orders received and accepted from federal government ordering activities or advance payments from non-federal entities.²² The concept of advance payment for government sales is also stated in OMB guidance:²³

User charges will be collected in advance of, or simultaneously with, the rendering of services unless appropriations and authority are provided in advance to allow reimbursable services.

Advance payment for goods or services is very often not required for transactions between trusted trading partners in the commercial world. One company's representative indicated that advance payment policy varies within industry. He stated that, in his business, advance payment is often required for purchase of equipment, but payment for services is required upon delivery. He also indicated that the size of a contract and whether up-front investments are needed to fulfill a contract influence requirements for advance payment.

ASSESSMENT

In two instances, 10 USC 2563 and 10 USC 4543 (for ordnance sales), the law permits a purchaser of goods and articles under these sections to use advance incremental payment of articles and services. While these sections do not require *full* payment upon placement of an order (as for government customers), the sections effectively require payment to take place before an increment of work is accomplished. We found no instance in which the law permits work to be performed by a DoD activity for a private entity in advance of payment (i.e., cash on delivery).

Establishing and implementing a policy to allow work on private sales orders to commence in advance of receipt of payment would likely require new legislation and additional working capital. Any such policy would apply only to trusted private entities in sound financial condition and with an established record of prompt payment, and would require a set of criteria that permit work in advance of the receipt of payment.

²² DoD 7000.14-4, Volume 11B, Chapter 11, paragraph 110103.

²³ OMB circular A-25, paragraph 6(c).

Administration of uniform criteria to allow work in advance of payment would add some amount of additional overhead cost to the process, and some amount of loss would be likely. Even the most seemingly sound and trusted parties occasionally encounter financial difficulties that impede their ability to pay for goods and services received. Collection of delinquent payments from private parties can be a lengthy and costly process, and the dismissal of significant losses requires the approval of the Department of Justice.²⁴

As a practical matter, advance incremental payment can be accomplished with enough frequency that substantially less of the private partner's capital is committed for work not yet done. Although this approach requires more financial transactions than a single payment upon delivery of a finished product, it may be a beneficial feature for negotiating partnerships.

ALTERNATIVES

We identified the two advance payment alternatives:

- ◆ *Seek new legislation* that authorizes work for private partners to be performed in advance of payment.
- ◆ *Update the FMR* to emphasize incremental advance payment as an option that can mitigate the need for a large up-front payment by private partners.

RECOMMENDATION: UPDATE THE FMR

We recommend the FMR be revised to emphasize the employment of advance payments in small increments for private-party sales.

IMPLEMENTATION OF RECOMMENDATIONS

DoD's Financial Management Regulation should be revised to include a special section on sales to private entities under public-private partnership arrangements. The FMR revision should include the following:

- ◆ Prices on sales to private entities as part of public-private partnership agreements should be based upon the current cost of operations, excluding AOR recovery factors, other surcharges, and unrelated overhead charges. The provisions of Volume 2A, paragraph 010218.B, and Volume 2B, paragraph 090103.H, that pertain to execution year surcharges to recover unbudgeted depot operating losses do not apply to sales to private entities in public-private partnership agreements
- ◆ Fixed price agreements in the sale of goods and services to private partners are encouraged to facilitate public-private partnering.

²⁴ DoD 7000.14-4, Volume 10, Chapter 18, paragraph 180102 and Volume 5, Chapter 31, paragraph 3102.

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- ◆ Multiyear firm, fixed-price contracts are encouraged and may be entered into in the case of sales to a private partner when there is a reasonable basis upon which to estimate future costs. Multiyear fixed-price agreements should take into account anticipated cost changes for labor and materials as estimated by OMB.
 - ◆ A small, locally determined contingency factor, which must not increase prices by more than 5 percent, may be included in prices to private partners to cover possible operating losses and to fund marketing of services to private entities as permitted by law. Proceeds from the contingency factor plus accumulated operating gains and losses related to private-partner sales will be placed in a separate account. This account is available only to offset any operating losses that are attributable to private-sector sales and for preparation of bids and proposals or other marketing efforts to further the objectives of public-private partnering.
 - ◆ Agreements for sales to private partners may be structured with multiple advance payments, thus mitigating the requirement for a large up-front payment for work.

We also recommend that the DUSD(L&MR) public-private partnership memo of 30 January 2002 be updated to include more detailed policy for pricing of sales to private entities by DoD depots in partnership agreements. The update should refer to appropriate sections of the FMR and include advance notice of any approved but not-yet-issued revisions to the FMR.

APPENDIX A. LEGISLATION AND DoD POLICY

Public Law

10 USC 2208

10 USC 2208 authorizes the Secretary of Defense to establish working capital funds (WCFs) to finance the production of goods and services and be reimbursed from available appropriations or otherwise credited for the cost of sales. Paragraph (j) permits WCFs to sell goods and services outside DoD to those fulfilling DoD contracts won pursuant to a public-private competition or when advancing the objectives of partnering as defined in 10 USC 2474(b)(2).

10 USC 2474

10 USC 2474 requires the designation of each depot-level activity as a center of industrial and technical excellence (CITE) in its recognized core competency. Each CITE may be authorized to enter into public-private partnerships. A depot may sell goods or services to a private entity related to one or more of its core competencies. Depots may also make equipment or facilities available to a private entity, but must be reimbursed for the direct and indirect costs attributable to the entity's use of the equipment or facilities. Amounts received for work performed under a public-private partnership are credited to the appropriation or fund that incurs the cost the work performed. The objectives of public-private partnerships are as follows:

- ◆ Maximize capacity utilization of a CITE.
- ◆ Reduce or eliminate the cost of ownership of a center in such areas as operations and maintenance and environmental remediation.
- ◆ Reduce the cost of DoD products produced or maintained at a center.
- ◆ Leverage private-sector investment in DoD depots for plant and equipment recapitalization and for promoting commercial business ventures.
- ◆ Foster cooperation between the armed forces and private industry.

10 USC 2539B

10 USC 2539b allows the Secretary of Defense (SECDEF) to accomplish the following:

- ◆ Sell, rent, lend, or give samples, drawings, and manufacturing or other information to a non-DoD entity.

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- ◆ Sell, rent, or lend government equipment or material to a non-DoD entity for independent research and development or for use in demonstrations to a friendly foreign government.
 - ◆ Make available—at an appropriate fee—the services of any government laboratory, center, range, or other testing facility for testing purposes.

10 USC 2563

10 USC 2563 allows the SECDEF to sell outside the DoD goods or services¹ produced by a WCF activity that are not commercially available in the United States. The SECDEF may waive this restriction for reasons of national security. 10 USC 2563 requires the following:

- ◆ The sale price must include, at a minimum, the variable costs, capital improvement costs, and depreciation costs associated with the articles sold.
- ◆ Sales are to be by a firm, fixed-price contract or, if agreed to by the buyer, a cost-reimbursement contract.
- ◆ The SECDEF must develop and maintain (from sources other than appropriated funds) working capital to be available for paying design costs, planning costs, procurement costs, and other costs associated with the articles or services sold.²
- ◆ Proceeds from sales of articles and services under this section must be credited to the funds incurring the costs of manufacture and performance.

10 USC 2667

10 USC 2667 allows leasing of real or personal property to a person outside DoD for no more than 5 years unless a longer period is determined to be in the national interest by the military department secretary.

- ◆ Compensation may be in-kind consideration or cash payment for the fair market value of the lease interest as determined by the secretary.
- ◆ Cash proceeds are to be deposited in a special U.S. Treasury account to be used by the secretary of the military department for facilities maintenance and support.
- ◆ At least 50 percent of the proceeds must be available at the activity where the proceeds were derived.

¹ Other than ordnance type items identified in 10 USC 4543.

² 10 USC 2563 does not specify the establishment of working capital to support commercial sales. A practical approach would be to establish a reserve account for this purpose, funded by a surcharge added to the price of private-party sales.

10 USC 4543

10 USC 4543 allows sales by an Army WCF facility that manufactures large caliber cannons, guns mounts, recoil mechanisms, ammunition, munitions, or munitions components to persons outside the DoD for certain purposes, including use in commercial products. 10 USC 4543 requires the following:

- ◆ The Secretary of the Army must determine the items are not commercially available in the United States.
- ◆ The sale price must include, at a minimum, the variable costs associated with the articles sold.
- ◆ Sales are by a firm, fixed-price contract or, if agreed to by the buyer, a cost-reimbursement contract.
- ◆ Army regulations shall authorize an Army depot or arsenal to develop and maintain (from sources other than appropriated funds) working capital to be available for paying design costs, planning costs, procurement costs, and other costs associated with the commercial articles or commercial services sold.

As in 10 USC 2563, this section does not provide specifics on establishment of working capital to support commercial sales.

10 USC 7300

10 USC 7300 exempts from the restrictions of Sections 2208 and 2563 sales by a naval shipyard to a private shipyard fulfilling a DoD contract for work on a nuclear ship.

22 USC 2770

22 USC 2770 permits the President to sell, on a negotiated contract basis under cash terms, defense articles to a U.S. company for incorporation into an end item to be sold to a friendly foreign government or international organization. The sale price is not to be less than the contract or manufacturing cost.

DoD Policy

DOD FINANCIAL MANAGEMENT REGULATION

The DoD Financial Management Regulation does not specifically address public-private partnering sales by DoD depots, but it provides guidance on pricing of sales to private parties.

- ◆ Volume 11B, Chapter 11, paragraph 110109.B, requires private parties reimburse the WCF activity for costs incurred by the federal government,

including unfunded costs³ such as unfunded civilian retirement and post-retirement health benefits costs. Amounts collected for these unfunded costs may not be retained by the WCF but are to be deposited in the U.S. Treasury.

- ◆ For sales to private parties by non-WCF activities, Volume 11A, Chapter 1, requires reimbursement for direct and overhead costs, unfunded retirement and post-retirement health benefits costs, military labor costs, and an asset use charge. The asset use charge consists of a 4 percent charge developed by DoD or the actual depreciation on plant property and equipment plus any interest on investment in assets.
- ◆ Volume 11A, Chapter 1, paragraph 010201.B and Volume 11B, Chapter 11, paragraph 110109.B, require amounts collected for unfunded retired costs and the asset user charge be deposited in the U.S. Treasury, as they are not funded by the performing activity.
- ◆ The FMR does not address the deposit or use of amounts collected for military labor that are not funded by the performing activity, although the regulation points out that performing activities may retain collections only to the extent authorized by law.
- ◆ Volume 11A, Chapter 2, paragraph 020702, specifies the conditions for use of a fixed-price project order. It is not clear if the paragraph applies to partnership agreements, because the FMR does not specifically categorize a private-party order as either a project order or an economy act order.⁴ In either case, the general policy stated in Volume 11B, Chapter 1, paragraph 010101.I.1, that “customer rates shall be established on an end-product basis whenever feasible” supports the concept of fixed pricing of a product.⁵

³ In other words, costs not directly funded by the depot maintenance activity.

⁴ A *project order* is for specific, definite output that may be accomplished over a period of time that can extend into a subsequent fiscal year. Project orders are not severable by fiscal year (i.e., few benefits would accrue if the work were terminated before completion). An *economy act order* applies to efforts that are severable, such as refuse collection, fire protection, or grounds maintenance on a reimbursable basis. Economy act orders automatically expire at the end of each fiscal year, so performance of the order may not extend into the next fiscal year.

⁵ The terms “rate” and “price” are discussed in a number of places in the FMR, including Volume 2A, Chapter 1, paragraph 010218; Volume 2B, Chapter 9, paragraph 090104B; and Volume 11B, Chapter 1, paragraph 010101.I.1. In essence, a stabilized customer rate (usually expressed in dollars per direct labor hour) is established (stabilized) for each depot maintenance WCF for each year. Using that rate, stabilized unit prices are then determined by multiplying the rate by the standard hours required to complete each job.

FEDERAL ACQUISITION REGULATION

The Federal Acquisition Regulation (FAR), subpart 45.3, contains guidance on providing government-furnished equipment, material, and facilities to a contractor or subcontractor. There are no FAR provisions related to pricing of sales to private entities by DoD activities.

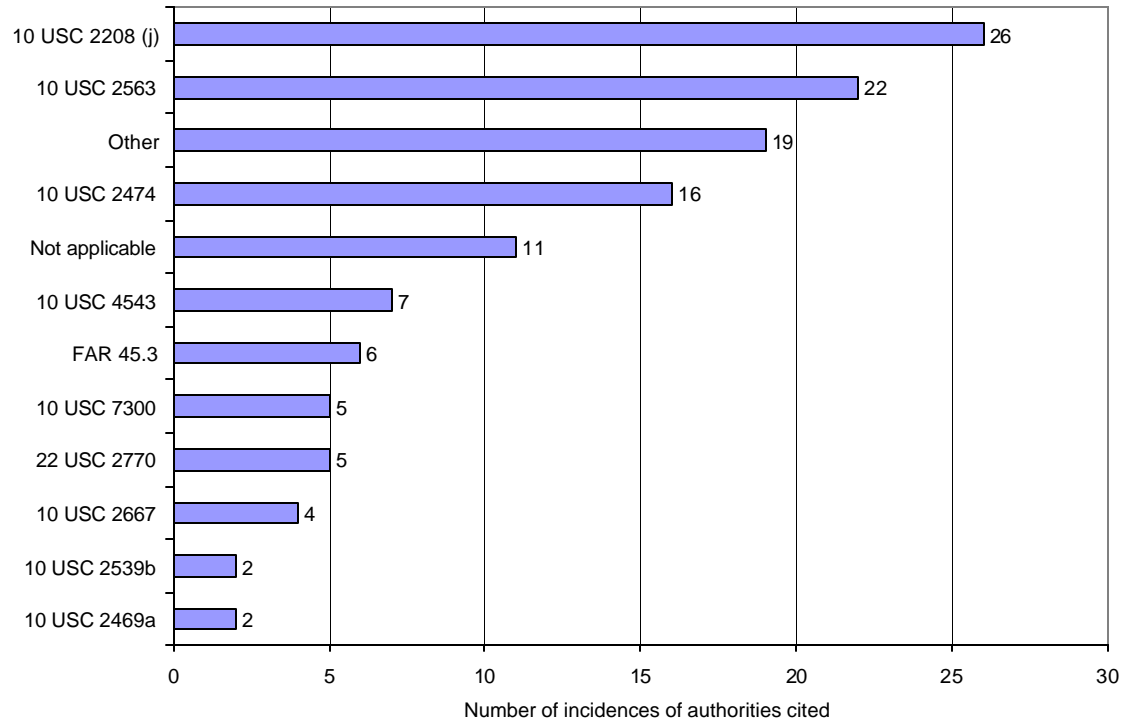
PUBLIC-PRIVATE PARTNERSHIPS FOR DEPOT MAINTENANCE

DUSD(L&MR) Memorandum, 30 January 2002, *Public-Private Partnerships for Depot Maintenance*, establishes interim policy on depot maintenance public-private partnerships. The memorandum requires activities participating in partnerships separately to track and report financial results, but does not provide guidance about pricing of goods or services sold to private partners.

APPENDIX B. PUBLIC-PRIVATE PARTNERSHIPS BY AUTHORITY

Figure B-1 charts how often the authorities from Appendix A were applied to establish public-private partnerships. 10 USC 2208 was the most oft cited authority among the 102 public-private partnerships developed.

Figure B-1. Authorities for Partnerships



Source: From the July 2003 draft report on *Public-Private Partnerships for Depot-Level Maintenance* prepared by the Joint Depot Maintenance Activities Group.

Note: Totals exceed the 102 reported partnerships because some partnerships were established under more than one authority.

Note: The provisions of 10 USC 2469a were repealed by P.L. 107-314, sec. 333(a), 116 Stat. 2514, but are cited in arrangements established prior to 2001.

APPENDIX C. TYPES OF PARTNERSHIPS

Partnership agreements may take any number of different forms, and may encompass several different types. The Joint Depot Maintenance Activities Group (JDMAG), which collects DoD information on partnering agreements, groups them into eight different types. Table C-1 lists these categories, along with the number of instances they are identified in the DoD.

Table C-1. Types of Partnerships

Type	Instances
<i>Sale of services</i> by a DoD depot to a private entity—the most commonly identified form of partnering	57
<i>Sale of articles</i> by a DoD depot to private partners	23
<i>Workshare</i> —an arrangement whereby government and commercial facilities or personnel are each separately employed and paid by a weapons system manager (The arrangement is generally directed by the weapons system manager and implemented by a memorandum of understanding or an agreement rather than a contract.)	26
<i>Teaming</i> —the partnering of government and commercial entities to accomplish a task or deliverable stated in a contract (The parties generally form a contractor/sub-contractor arrangement.)	27
<i>Lease of facilities and equipment</i> to private entities	10
<i>Lease of facilities only</i>	4
<i>Provide government-furnished resources</i> to private entities	11
<i>Other partnership types</i>	5

Note: The total number of instances cited exceeds the number of partnerships because a single partnership can constitute two or more partnership types.

APPENDIX D. REASONS FOR PARTNERING

The reasons for entering into a public-private partnership are varied. A recent GAO report¹ categorizes these, as reported by DoD depots, as reflected below (with the number of instances in parenthesis).²

TableD-1. Reasons for Partnering

Reasons	Instances
Unique capabilities of DoD depot	57
Advantageous labor rates charged by the DoD depot	13
Workshare arrangement directed by the program manager	12
Title 10 limits on outsourcing of core functions	10
Contractor closed a facility	4
DoD facility closed under Base Realignment and Closure Act	4
Reduce turnaround time	4
Facilitate workforce sharing	1

¹ GAO-03-423, April 2003, Depot Maintenance, *Public-Private Partnerships Have Increased but Long-Term Results Are Uncertain*.

² GAO reviewed 90 partnerships; 105 reasons were recorded because more than one reason was cited for many of the partnerships.

APPENDIX E. ABBREVIATIONS

AOR	Accumulated Operating Result
CITE	center of industrial and technical excellence
DUSD(L&MR)	Deputy Under Secretary of Defense Logistics and Materiel Readiness
FAR	Federal Acquisition Regulation
FMR	Financial Management Regulation
GAO	General Accounting Office
JDMAG	Joint Depot Maintenance Activities Group
OMB	Office of Management and Budget
OSD	Office of the Secretary of Defense
SECDEF	Secretary of Defense
USC	U.S. Code
WCF	Working Capital Fund